12.02 Contingencies

A contingency is a gain or loss that may occur in the future as a result of an existing condition. (ASC 450)

Contingent Liabilities

The event occurs before the balance sheet date, but the resolution is contingent upon a future event. We are concerned with the existence of the liability. Examples include:

- Obligations related to product warranties.
- Pending or threatened litigation.
- Obligations related to product defects.
- Threat of expropriation of assets.

Loss Contingencies

- **Remote** – slight chance of occurring
  - Don't disclose
  - Don't accrue
- **Reasonably Possible** – more than *remote*, less than *probable*.
  - Disclose nature and range of loss
  - Don't Accrue – Fair presentation
- **Probable** – "Likely" to occur
  - If **not Estimable**
    - Disclose nature and range of loss
    - Don't Accrue
  - If **Estimable**
    - Disclose nature and range of loss
    - Do Accrue
      - Conservatism / Matching

A **remote** contingency is a loss that is reasonably certain not to occur. There are virtually unlimited numbers of different things that can go wrong in a business, and to attempt to identify all of them in the financial report would actually defeat the attempt to fairly present the company. It would distract the user from more significant risks with greater chances of occurring. Although disclosure of remote contingencies isn't forbidden, it is only required in one circumstance: when the client has guaranteed the debt of another party.

If a loss is **reasonably possible**, it must be disclosed in the notes to the financial statements, including the nature of the contingency and the range of possible losses. Accrual of the loss on the financial statements is forbidden, since the loss is still not probable. Accrual would bias the

presentation of the financial numbers to the downside, violating the **neutrality** ingredient of **Faithful representation**, one of the primary qualitative characteristics of accounting information. The client may, however, appropriate a portion of retained earnings for reasonably possible losses so as to indicate that these amounts are not available to pay dividends to shareholders.

When a loss is **probable** it will, of course, be disclosed. In addition, though, we should accrue the expected amount of loss. The problem is that it is difficult to establish a verifiable number for the loss. If it is possible to estimate an amount, this will be reported on the income statement and reduce net assets on the balance sheet. For example, if the client is being charged with breach of contract in a case which the client's attorney believes is probably going to be lost, and the contract in question specified the monetary damages for breach at $300,000, or the client has insurance coverage that will limit their loss to $300,000 in any event, the entry might be:

Estimated losses from legal claims	300,000	
Estimated liability from legal claims		300,000

- **If a Range of Loss**
  - Accrue amount "most Likely" to occur.
  - If any amount is as likely as the rest, accrue the minimum amount in the range and disclose the range.
- **Unasserted Claims** (eg, potential lawsuit – not yet initiated)
  - If not probable that claim will be asserted
    - No disclosure, no accrual
  - If Probable that the claim will be asserted
    - Look at likelihood of loss
    - Remote, Reasonably Possible, Probable
- **Uninsured Losses** – potential loss for which company has no insurance.
  - If don't expect condition to occur, do nothing
  - If expect to occur, Disclose.
  - If occurred, Accrue and Disclose.

Gain Contingencies

- Disclose if Reasonably possible or Probable, the nature and amount.
- Never accrue until realized
  - Conservatism

Loss Contingency	Disclose	Accrue
Remote – Slight	No	No
Reasonably Possible	Yes	No
Probable & Estimable	Yes	**Yes**
Probable & Not Estimable	Yes	No

Estimated Loss (I/S)
Estimated Liability (B/S)

Gain Contingency	Disclose	Accrue
Remote = Slight	No	No
Reasonably Possible	Yes	No
Probable & Estimable	Yes	**No**

Subsequent Events

Events occurring during the time interval between the balance sheet date but before the date that the financial statements are issued or are available to be issued, may have an impact in one of two ways:

- **Type 1** – Some events provide evidence of **conditions existing** at the balance sheet date that require **adjustment (recognized)**. For example, the bankruptcy filing of a customer on January 4, 20X1 may indicate that a receivable from that customer at December 31, 20X0 ought to be written off. Another example might be the settlement of a litigation for an amount different than the amount that had been accrued.
- **Type 2** – Some events do not affect the balance sheet, as the **condition did NOT exist** at the balance sheet date, but still represent important information that should be **disclosed (nonrecognized)** to assist users of the financial statements in interpreting them. For example, a fire that destroyed the company's main warehouse on January 4, 20X1 does not change the inventory balance at December 31, 20X0, but would affect the significance of that inventory and suggest possible future difficulties. Other examples include sale of bonds or issuance of stock, purchase of a business, fire or flood loss, receivable loss.

Summary

Subsequent to B/S date but before issue financial statements.

- **Type I**
  - Condition **Existed at B/S date** (eg, Lawsuit is settled or IRS assessment).
  - Accrue and disclose (recognized). Use original report date 3/1.

- **Type II**
  - Condition **did not Exist** at B/S date (eg, Issue bonds after year end).
  - **Disclosure (nonrecognized)**, but do not Accrue. Either dual date report or date report as of event date (if after field work date).